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SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1906.

No. 80.

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JAMES H. McKENNE
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FRANKLIN S. JEROME,
Plaintiff in Error,

vs.

CHARLES P. COGSWELL, THE STATE SAVINGS BANK, ET AL.

IN ERROR TO THE SUPREME COURT OF ERRORS OF CONNECTICUT.

BRIEF OF DEFENDANTS.

HADLAI A. HULL, } *of*
FRANK T. BROWN, } *Counsel.*

BULLETIN PRINT, NORWICH, CONN.

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STATEMENT.

Prior to the reduction of its capital stock, The Second National Bank of Norwich was, and for many years had been, a banking association, organized under the Act of Congress with capital stock amounting to $300,000, and located in the Town of Norwich, in the State of Connecticut.

In the latter part of 1899 the officers of the bank, having in contemplation a reduction of the capital stock, communicated with the Comptroller of the Currency, and the bank received from him a letter, dated December 4th, 1899, which is made a part of the finding as Exhibit "A." (Record, page 29.)

The next step in the proceedings was a vote of the directors, instructing the Cashier to prepare and submit to the next meeting of the Board a notice and circular to be sent to the stockholders recommending the reduction of the capital from $300,000 to $200,000. (Record, page 30.)

On March 9th, 1900, the Comptroller wrote to the Cashier of the bank acknowledging receipt of this letter of March 8th, and copy of notice of stockholders' meeting called to consider the matter of reduction, and advising him that in case the reduction was made it would be necessary to obtain the consent of each shareholder to the retention of any money not necessary for retiring bad and doubtful assets of the bank. (Record, page 30.)

A meeting of the stockholders was held on April 3rd, 1900, and the proposition to reduce the capital stock failed to receive the necessary vote. (Record, page 31.)

On May 9th, 1900, the directors again voted to call a meeting of the stockholders to consider the question of reduction. (Record, page 31.)

On May 15th, 1900, the Comptroller of the Currency wrote the Cashier of the bank acknowledging his letter of May 9th in reference to the reduction of the stock from $300,000 to $200,000, and informing him that the reduction would be approved provided so much of the amount as might be necessary should be used to charge off bad, doubtful and unproductive assets, the difference only being paid to the shareholders in cash. (Record, page 32.)

On May 19th the Comptroller wrote to the President of the bank acknowledging receipt of his letter of May 18th, and copy of notice of stockholders' meeting to be held on the 24th for the purpose of considering a reduction of the capital stock, and advising the President that he would approve of the reduction upon the condition that so much only of the capital set free as should be necessary to charge off bad, doubtful and unproductive assets should be used for that purpose, and that if the whole amount of the reduction in capital was not required for that purpose, the consent of each shareholder must be obtained to the withholding from him of any money to which he might be entitled by reason of the reduction, and that the shareholders of a national bank, upon a reduction of its capital stock, are entitled to either receive the cash or the charged off assets, and that neither can be withheld without their consent, and that the Comptroller's office did not approve of the recommendation of the directors that the assets of the bank should remain the same, the number of shares simply being reduced. (Record, page 32.)

The Comptroller also had an interview with the President of the bank in reference to the reduction of the capital stock and said to him that he must remember that the assets belong to the stockholders of record and a trust fund must be created so that

those assets might be distributed among the stockholders of record at the time of the reduction. (Record, page 23.)

On May 24th, 1900, a meeting of the stockholders was held at which the proposition to reduce the capital stock of the bank from $300,000 to $200,000 received the vote required by law. (Record, page 33.)

On June 9th, 1900, the directors of the bank notified the Comptroller in writing that the amount of the reduction of the capital stock, namely $100,000, would be used for the purpose of charging off bad, doubtful and unproductive assets, and that no money would be paid to the shareholders unless realized from said assets, which were to be set aside and collected for the benefit of the shareholders of record at date of issuance of the Comptroller's certificate approving the reduction, and requesting that the Comptroller issue a certificate of approval of the reduction of the capital stock. (Record, page 34.)

And on June 9th the Comptroller, in a written communication to the President of the bank, stated that he enclosed in the communication his certificate approving the reduction of the capital stock, and that the certificate is issued in view of the statement filed with the Comptroller on said day to the effect that the whole amount of the reduction would be used to charge off bad, doubtful and unproductive assets, and no money would be paid to the shareholders unless realized from said assets. (Record, page 34.)

On June 27th the directors voted that the assets which are in dispute in this case, and on account of which the reduction of the capital stock was made, be set aside from the other assets of the bank, and be held by it in trust for the stockholders of record on June 9th, 1900 (which was the date of the Comptroller's certificate of approval), and that whatever might be realized from said assets be distributed from time to time, as might be reasonable, among said stockholders in proportion to their respective holdings on said date. (Record, page 35.)

Annexed to the vote was an itemized statement of the assets, a part of which consisted of real estate standing in the name of the bank, and the balance choses in action. As a matter of book-keeping and to make out a balance-sheet, the capital stock of the bank was credited with the reduction of $100,000, and profit and loss was charged to the amount of $100,307.86, being the face value of the assets incorporated in the vote of the directors of June 27th.

From June 27th, 1900, the bank treated these assets as the property of the stockholders of record June 9th, 1900. The net amount of whatever was received from them was carried as a distinct item in the books of Daily Balance Credit as a credit to "Stock-trust," and a ledger account was opened with "Stock-holders' Trust," and all receipts were credited to that account and all expenses incurred in realizing on the assets were charged up to it, and so far as the books of the bank were concerned, these assets were always treated as a special fund belonging to the stockholders of record June 9th, 1900. (Record, pages 24 *et seq.*, also page 55.)

From the sale of the real estate and collections of the choses in action the receiver now has in his hands, after deducting all expenses, $20,240.00, and has also some of the assets in specie of the value of about $2,000. (Record, pages 25, 55.)

At the time of the reduction of the capital stock the net actual capital of the bank applicable to stock was, exclusive of the assets in question, of the actual value of between $240,000 and $250,000, that is to say, excluding the assets in question the bank had, after reducing the stock to $200,000, a surplus of between $40,000 and $50,000. (Record, pages 47, 55.)

All of the defendants except the receiver were on June 9th, 1900, and had been for a long time prior thereto, stockholders of record of said bank to the extent shown in the finding, and the defendant, Cogswell, has since become the owner of additional

shares, and also of the rights in these assets of sundry parties who were stockholders of record on June 9th, 1900. (Record, pages 24, 25.)

After July 1st, 1900, the stockholders surrendered their certificates and received certificates for two-thirds of their former holdings. Most of the defendants have sold and transferred their shares, but none of them have sold or disposed of any rights in the assets in question, unless the mere transfer of their shares without expressly reserving their rights carried with it such rights as a matter of law. (Record, page 26.)

The assets in question were separated from the other property of the bank and set aside as the property of the stockholders of record at the date of the reduction of the capital stock in compliance with a promise made by the president and directors of the bank to the Comptroller, without which promise his approval of the reduction of the capital stock could not have been obtained. (Record, page 56.)

There is no finding in respect to the ownership of stock by the plaintiff, Jerome, except that he was a stockholder on the 24th day of February, 1903, the date of the expiration of the bank's charter.

After the expiration of the charter the present action was brought by a shareholder and a receiver appointed who has in his possession the disputed assets.

The Supreme Court of Errors of Connecticut decided that the fund in dispute belongs to the shareholders of record at the date of the reduction of the bank's capital stock, viz., June 9, 1900.

That the interests of the plaintiff, Jerome, were in any way affected by the decision is not apparent from the record because the only finding as to his ownership of stock is that he owned certain shares at the date of the expiration of the bank's charter

viz., February 24, 1903. It does not appear when he acquired them, or whether it was before or after June 9, 1900.

The general statement of the plaintiff's complaint contained in his assignment of errors is that the Connecticut Court erred in adjudging that he was not entitled as a shareholder of the bank to his proportionate share of the assets in dispute, and that thereby he was deprived of a right and privilege to which he was entitled under certain enumerated sections of the statutes of the United States. (Record, page 58).

The special assignments are in substance that the court attributed to the Comptroller of the currency under section 5143 an authority which he did not possess; that it put a wrong restriction on the effect of his certificate of approval and the condition upon which it was given; that it assumed a power on the part of the directors under the banking act to appropriate the fund in dispute to the benefit of shareholders of record at the date of the reduction of the capital stock, and to separate it for that purpose from the property of the bank, when they possesed no such power; that it held improperly that the assets in questions were under the circumstances the equivalent of net profits within the meaning of sections 5199, 5204 of the National Banking Act, and that the action of the directors could be sustained as a dividend under those sections; and that the plaintiff was thereby deprived of a right to a proportionate share of the fund under section 5139 as a transferee of shares of stock. *Ibid.*

It nowhere appears in the record that the plaintiff claimed any such right in the state court unless it is inferred from the language of the opinion. (Record, pages 54-57.)

If it is assumed that he did, his real complaint is that the state court by erroneously attributing to the Comptroller and the bank directors an authority under the National Banking Act which they did not possess, deprived him of a right which belongs to him *not under any statute of the United States* but under *a rule of*

law applicable to corporations generally, unless indeed he can establish his right under section 5139.

If his interests were affected by the decision we submit the following

REASONS WHY THE WRIT SHOULD BE DISMISSED OR THE JUDGMENT OF THE STATE COURT AFFIRMED.

FIRST.

The state court denied to the plaintiff no right to which he was entitled under any of the sections of the National Banking Act enumerated in his assignments of error. The purpose of sections 5199 and 5204 is to keep the capital of a bank intact and to provide for the accumulation, under certain conditions, of a twenty per cent. surplus. The appropriation of the fund in dispute to the stockholders owning shares on June 9, 1900, left the capital of the bank intact and a surplus of more than twenty per cent., (although on a reduction of the stock it does not seem to us that this was necessary or could have been done lawfully if contested by the shareholders,) and the state court might properly treat the act of the bank directors as a division of what was equivalent to net profits.

Section 5204 seems to contemplate such a distribution of assets because it provides that, "Nothing in this section shall prevent the reduction of the capital stock of the association under section 5143."

Section 5139 provides that "Every person becoming such shareholder by such transfer shall in proportion to his shares succeed to all the rights and liabilities of the prior holder of such shares." It does not attempt to define what the rights are, but leaves them to be determined by general rules of law. There is no finding that the plaintiff held any shares *by transfer,* and if he did the state court has denied him no right under the statute, but

has decided, in accordance with general rules of law, that after the trust fund was created no interest in it attached to the shares of stock, or went with them on a transfer any more than would a cash dividend declared before a transfer. This presents no federal question.

Eustis, et al., v. Bolles, et al., 150 U. S. 361.
Leyson v. Davis, et al, 117 U. S. 36.
Baker v. Baldwin, 187 U. S. 75.
Mutual Life Ins. Co. v. McGrew, 188 U. S., 291.
Beals v. Cone, et al., 188 U. S., 435.

The state court committed no error in deciding that the Comptroller of the Currency had the right under section 5143 to protect the legitimate interests of the shareholders when he gave his approval of the reduction of the capital stock. The right is fairly implied from the powers given to him by the Statute, the protection was reasonable, and the method adopted was proper for the reasons hereinafter given, but whether the Court was right or not, the decision denied no right of the plaintiff under the statute because he claimed none. He claims simply that the construction given to the statute deprived him of rights to which he was entitled by general rules of law.

The board of directors was the proper body to separate the assets in question from the other assets of the bank and divide them among the stockholders under section 5145 for the reasons given later, but if it were otherwise the plaintiff claims for himself no right to the assets under that section. The other sections of the statute mentioned were not drawn in question in the case. If the record presents any federal question, and we claim it does not, no decision upon it by the state court deprives the plaintiff of any right under a statute of the United States.

SECOND.

If the action of the bank's directors was not a dividend of what was equivalent to net profits, its validity can be supported on other grounds, and we submit for the court's consideration the following

GENERAL PROPOSITIONS OF LAW.

1. When the assets of a national bank become so reduced in value that the net actual capital of the bank applicable to capital stock is insufficient to make it worth its par value, and a reduction of its capital stock is made, simply sufficient to make the reduced capital stock worth par, there can be no distribution of assets.

2. When the capital stock of a national bank is reduced and there is no impairment of its capital, there must be a distribution of assets among the stockholders of record at the date of the reduction.

3. When the net actual capital of a national bank applicable to capital stock is insufficient to make the stock worth par and a reduction of capital stock is made, but to an extent greater than is necessary to meet the impairment, so much of the net actual capital as is not necessary to make the reduced stock worth par, should be distributed among the stockholders of record at the date of the reduction.

4. It is within the authority of the Comptroller of the Currency to condition his approval of the reduction of capital stock on the adoption of such measures as he may think proper to do justice to the holders of the original shares.

5. The right of the stockholders to a distribution, as stated in (2 and 3), is not, however, dependent upon any action of the Comptroller, but belongs to them under the law independently of any action on the Comptroller's part.

POINT I.

There was no controversy in the State Court over the first proposition. It is supported by the authority of McCann v. First National Bank of Jeffersonville, 112, Ind. 354, McCann, Trustee v. First National Bank of Jeffersonville, 131 Ind. 96, 97, and we refer to it only because the reasoning of the Indiana Court by implication supports our second proposition.

POINT II.

The National Banking Act provides for the reduction of the capital stock of a bank as follows: "Section 5143. Any association formed under this title may by the vote of shareholders holding two-thirds of its capital stock reduce its capital to any sum not below the amount required by this title to authorize the formation of associations; but no such reduction shall be allowable which will reduce the capital of the association below the amount required for its outstanding circulation, nor shall any such reduction be made until the amount of the proposed reduction has been reported to the Comptroller of the Currency and his approval thereof obtained."

We have found only two cases in which the disposition of assets of a national bank upon the reduction of its capital stock, under this provision, has been considered and passed upon They are the Indiana case, cited above, and Seeley v. The New York National Ex. Bank, 8 Daley, 400 (affirmed 78 N. Y., 608.) We see no conflict between these cases. The Indiana Court decided that where the reduction was required to meet an actual impairment of capital and to prevent an assessment upon the stockholders threatened by the Comptroller of the Currency, there could be no distribution of assets because all the assets were necessary to make the reduced stock worth par and any withdrawal of assets would produce a new impairment of capital and defeat the purpose of a reduction.

"It must be remembered that the reduction of the capital stock of the bank was in a sense involuntary and was to meet an impairment of equal amount. It must be presumed that the Comptroller of the Currency, in estimating and determining the amount of the impairment, considered all of the assets of the bank and that his estimate was based upon what then appeared to be their value, making proper allowance for assets depreciated in value and for those regarded as worthless. . . . . There can be no voluntary withdrawal of any portion of the assets of a bank

where the effect of such withdrawal will be to impair the capital stock or endanger the security of its creditors. On the facts before us, it will be presumed that the reduced capital stock represented the actual value of the remaining assets; *prima facie*, any further withdrawal of assets, whether of great or of little value, would result in still further impairment of the capital."

McCann, Trustee v. First National Bank of Jeffersonville, 131 Ind., 96, 97.

If the rule rests on that foundation, when the foundation is removed the rule falls. If there is any general rule that there can be under no circumstances a distribution of assets when the capital stock is reduced, it is superfluous to support it by any such reasoning as is found in the Indiana cases, but if the general rule is, that where a part of the stockholder's shares are taken from him by the corporation by a reduction of its capital stock (perhaps without his consent) he is entitled to have returned to him an equivalent in the assets of the corporation, then the reasoning of the Indiana Court is pertinent and its purpose can be understood.

In the New York case there was no impairment of capital. The reduction of $200,000 was made with the purpose of distributing $100,000 among the stockholders and adding $100,000 to the bank's surplus. The Comptroller of the Currency imposed no condition and made no order as to the disposal of any assets upon the reduction of the capital stock. The bank not only made no attempt to distribute the $100,000 in dispute, but undertook to withhold it from the stockholders and carry it to the surplus. The dissenting stockholder stood solely upon his right under the law to have his proportionate share of the assets returned to him and the Court upheld his claim.

The shares of stock represents the net actual capital of the bank and when there is no impairment none of the shares of the stockholders should be taken from them, except in exchange for the assets they represent. The New York Court recognized the fact, long well known in the business world, that when a reduction of the capital stock is made the stockholder's reduced hold-

ings will probably not be worth as much as his original holdings. Two shares of a capital stock of $200,000 will bring more in the market than one share of a capital stock of $100,000, although both are based upon the same assets. It is the knowledge of this fact (used in the judgment of many unwarrantably and contrary to the public welfare) which is the explanation of excessive capitalization of corporate assets but whatever may be thought of its use in such cases, the fact remains; and the strictest moralist has never contended that a stockholder in a corporation is under any obligation to suffer a depreciation of his property that the corporation may create a surplus not prescribed by law. The stockholder's proportionate interest may be the same after the reduction as before but the financial aspect of the case is much more interesting to him than the mathematical.

"When the capital stock is reduced, the amount so set free belongs to the stockholders in proportion to the number of shares held by each, and it must be returned to them; it cannot be retained by the bank for a surplus fund or for any other purpose. In this matter the directors have no discretion (Seeley v. New York National Exchange Bank, 8 Daley, 400; affirmed 78, N. Y. 608), and as such capital ceases to be the property of the corporation and becomes the property of the individual stockholders, its retention by the bank cannot be authorized by a majority of the stockholders no matter how large; but each stockholder is entitled to claim his portion and cannot be deprived of this right against his own consent." Pratt's Digest, Ed. 1905, p. 41. See Thompson on Corporations, Vol. 2, Sec. 2118, Cycl. Law and Procedure, Vol. 5, p. 436. Strong v. Brooklyn Cross-Town R. Co., 93 N. Y., 426.

At the time of the reduction of the capital stock of the Second National Bank its net actual capital applicable to stock was, exclusive of the assets in dispute, between $240,000 and $250,000, so that when the reduction was completed the bank had a surplus of between $40,000 and $50,000 without taking the disputed

assets into consideration. These were worth between $20,000 and $30,000. Prior to the reduction, the bank's capital was therefore somewhat impaired, probably to an amount between $30,000 and $40,000.

We have then a case presenting some of the features of the New York case and some of the features of the Indiana case. That is to say we have a reduction of the capital stock, part of which was needed to meet impairment of capital and part of which was not. We submit that so far as the reduction was necessary to meet the impairment of capital, that is to say, to produce an equality between the nominal amount of stock and the net actual capital applicable to stock, there could be no distribution, but that the reduction beyond that amount warranted and required a distribution on the principle laid down in the New York case. We cannot see that the situation is any different from what it would have been if a reduction had first been made sufficient to meet the impairment, and subsequently another reduction had been made. The substantial rights of the stockholders cannot be affected by the method adopted by the bank in effecting the reduction.

The amount of capital stock prior to the reduction, the amount of capital stock as reduced, and the net actual capital of the bank applicable to stock are decisive elements in ascertaining whether any capital is set free. We contend, therefore, that independently of any action of the Comptroller of the Currency, except his approval of the reduction of the capital stock, and independently of any action of the board of directors, the stockholders of the bank of record June 9, 1900, had a right to require a distribution among them in proportion to their respective holdings, of all the net actual capital of the bank in excess of $200,000. The directors of the bank having set aside a part of such excess their action was lawful and the stockholders of June 9, 1900, are entitled to that fund, so far as it has not been converted into cash, and to whatever cash has been realized from the disposition of any part of it.

POINT III.

It was fairly within the authority of the Comptroller of the Currency to condition his approval of the reduction of the capital stock of the bank on the adoption of such measures as he might think proper to do justice to the holders of the original shares. Cogswell v. Second National Bank, 76 Conn., p. 261. This is the language of the Connecticut Court in reference to the power of the Comptroller to require the distribution of the fund in question among the stockholders at the date of the reduction. The facts found show that the Comptroller did make such requirement as a condition of his approval of the reduction. He required a statement from the president and from the directors that that course would be taken, and the vote of the directors of June 27, 1900, was in fullfilment of the promise made by the directors to the Comptroller on June 9, 1900. Of course the promise could not be carried out until after the Comptroller issued his certificate, for until that was done, the reduction of the capital stock was not complete.

The State Court was right in holding that the condition imposed by the Comptroller need not be incorporated in his certificate of approval. There is nothing in the law requiring it to be there, and there is no reason why a condition to be performed after the approval took effect should be there. If the Comptroller had the right to impose the condition he could properly make it known to the bank in any way he saw fit. He could not say in his certificate, that his approval would not be given until after the condition was complied with, because the condition could not be complied with until after his approval was given. Presumably the Comptroller was familiar with the practice of the office, and it is perhaps not going too far to say that his construction of the Act of Congress is entitled to consideration.

POINT IV.

It may be claimed by the plaintiff, Jerome, that the assets should have been set aside by vote of the stockholders instead of the directors. Section 5145 of the Act of Congress provides that "the affairs of each association shall be managed by not less than five directors." The directors of a national bank are the managing body, and the action of the directors of the Second National Bank in this case was simply the performance of a duty imposed upon the bank by the law, and by the Comptroller of the Currency. There was no more occasion for calling the stockholders together than there would have been in the transaction of any ordinary bank business.

We submit that the writ of error should be dismissed for want of jurisdiction or the judgment of the State Court should be affirmed.

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